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In The

Supreme Court of the United States

GARY K. BIELFELDT AND CARLOTTA J. BIELFELDT,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether a judicial interpretation of 26 U.S.C. § 1221(1) that fails to treat stock in trade as an independent exclusion to the definition of "capital asset" violates both the plain meaning of the statute and its legislative history?

LIST OF PARTIES

Pursuant to U.S. Supreme Court Rule 14.1(b), all the parties to the proceeding are set forth in the caption of this case.

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PETITION FOR WRIT OF CERTIORARI

Petitioners respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Federal Appeals for the Seventh Circuit is reported at 231 F.3d 1035 (7th Cir. 2000), and is reprinted in the Appendix at App. 1-7.

The opinion of the United States Tax Court is reported at 76 T.C.M. (CCH) 776 (1998), and is reprinted in the Appendix at App. 8-42.

JURISDICTION

The United States Court of Federal Appeals for the Seventh Circuit entered its judgment on November 8, 2000.[1]

Petitioners' Petition for Panel Rehearing was denied on January 8, 2001. App. 48. This petition is filed within 90 days of the date of the denial of petition for panel rehearing as allowed by 28 U.S.C. § 2101(c) and U.S. Supreme Court Rules 13.1 and 13.3. The jurisdiction of this Court to review the judgment of the United States

[1] On November 9, 2000, a corrected judgment was filed to reflect that the judgment of the United States Tax Court was affirmed, not the judgment of the District Court. App. 47.

Court of Federal Appeals for the Seventh Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

The relevant statutory provision is 26 U.S.C. § 1221(1) (redesignated § 1221(a)(1) by the Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 532, 113 Stat. 1918, 1928-1931 (1999)), which provides in pertinent part:

> IN GENERAL – For purposes of this subtitle [dealing with income taxes], the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

STATEMENT OF THE CASE

A. FACTS

Between 1984 and 1989, Gary K. Bielfeldt (hereinafter "Bielfeldt")[2] was recognized as a major participant in the primary market for U.S. Treasury securities, particularly

[2] Carlotta J. Bielfeldt is the wife of Gary K. Bielfeldt, and is a party to this litigation only because the couple filed a joint tax return for the years in issue. Therefore, all references to "Bielfeldt" hereinafter shall refer to Gary K. Bielfeldt.

in the market for Treasury Notes and Treasury Bonds. During a period of exploding federal deficits, it is uncontested that Bielfeldt's involvement in the Treasury auction system and when-issued trading[3] provided necessary liquidity to the Federal Reserve, and helped ensure efficient pricing and distribution of Treasury securities.

Of the annual Treasury auctions held for Treasury Bonds and Notes between 1985 through 1989, Bielfeldt was awarded Treasury Bonds or Notes in 53.66% of these auctions in 1985, 35.90% in 1986, 34.29% in 1987, 22.86% in 1988, and 22.22% in 1989. During these years, Bielfeldt was awarded Treasury Bonds or Notes in 64 Treasury auctions; in 27 of these auctions, he was awarded 5 percent or more of the total supply up for auction; and in 13 of these 27, he was awarded 10 percent or more of the available supply. These positions represent billions of dollars worth of Treasury Bonds and Notes.

In addition to Treasury auctions, an equally important component of the primary market for Treasury securities is the when-issued market and off-auction activity (including repurchase and reverse repurchase agreements). When-issued trading serves a crucial function in the efficient operation of the Treasury cash market by reducing price uncertainties. A 1992 report prepared jointly by the Department of Treasury, the Securities and Exchange Commission, and the Board of Governors of the

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[3] The term "when-issued trading" refers to the period of time between the date that the U.S. Treasury announces an upcoming auction of Treasury securities, and the date of issuance of those securities.

Federal Reserve System acknowledged the critical role of when-issued trading and financing:

> [When-issued trading] benefits the Treasury by serving a price discovery function and by stretching out the actual distribution period for each issue, thereby allowing the market more time to absorb large issues without disruption.[4]

The impact of when-issued trading, along with other innovations in the Treasury market, "benefited the market and the taxpayer by increasing liquidity, thereby lowering the government's financing costs."[5]

The record below clearly established that Bielfeldt was heavily involved in when-issued trading, often at the request of "primary dealers" (registered specialists in Treasury securities who are required to provide liquidity to the U.S. Treasury and make markets in Treasury securities), to help determine the price and demand for an upcoming Treasury auction. If one combines the number of Bielfeldt's when-issued trades that did not subsequently result in an auction award (to avoid double-counting), then Bielfeldt's participation in the annual auctions for Treasury Notes and Bonds is more accurately 62.5% in 1985, 70.0% in 1986, 40.0% in 1987, 37.5% in 1988, and 30.0% in 1989.

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[4] *See* Department of the Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve, *Joint Report on the Government Securities Market*, at 9 (January 1992) ("Joint Report"). This Joint Report is available from the U.S. Government Printing Office and was included in the record below.

[5] Joint Report, *supra* n. 4, at 1.

It is uncontested that Bielfeldt's participation in the primary market for Treasury securities played a vital role in lowering the government's financing costs. As noted by (now) U.S. Senator Jon S. Corzine, the person responsible for the trading of Treasury securities at Goldman Sachs (a large primary dealer in this market) during the tax years at issue, Bielfeldt's participation in the auction system "contributed to the efficiency and liquidity of the Treasury securities market and a likely lowering of the overall cost of Treasury financing."[6] The importance of lowering the government's financing costs cannot be overstated. As stated by the government itself, "[a]n increase in financing costs of only one basis point – one hundredth of one percentage point – would cost taxpayers over $300 million each year."[7]

On his original tax returns during these tax years, Bielfeldt faithfully reported approximately $130.6 million in taxable income related to his activity in this market, and paid the resulting income tax.[8] During this same period, however, Bielfeldt economically realized a net loss from his involvement with Treasury securities of approximately $37.4 million.[9]

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[6] Mr. Corzine's testimony is included in the record below.

[7] Joint Report, *supra* n. 4, at 3.

[8] Because the bulk of Bielfeldt's gain from the sales of Treasury securities were short-term capital gain, he was not tax-advantaged by his original return position because he paid income tax on those gains at the ordinary income tax rates, not the more generally favorable capital gain rates.

[9] By originally reporting his net losses from sales of Treasury securities as capital losses, Bielfeldt maximized his income tax liability because he was unable to offset those capital

In July 1991 Bielfeldt corrected his tax position to conform to the economic reality of his activity by filing amended tax returns for 1982, 1984, 1985, 1986, 1987, 1988, and 1989 seeking approximately $85 million in federal income tax refunds on the basis that his gains and losses resulting from his involvement with Treasury securities were ordinary in nature. After the Respondent denied these refund claims, Bielfeldt timely filed suit in the Tax Court, arguing, in part, that his Treasury securities constituted his "stock in trade" under 26 U.S.C. § 1221(1), regardless of whether the Tax Court found that he held the securities primarily for sale to customers.

In support of his claim that he was a specialist in Treasury securities (*i.e.*, his "stock in trade"), Bielfeldt called numerous representatives from the primary dealers, whose collective testimony established the following: (1) Bielfeldt made markets in Treasury securities and provided necessary liquidity to the Treasury; (2) Bielfeldt's trading theory and source of profits in the primary market for Treasury securities was no different from the primary dealers (who are entitled to treat resulting gains and losses as ordinary in nature); (3) the primary dealers recognized and utilized Bielfeldt as a valuable source of supply for Treasury securities; and (4) primary dealers treated Bielfeldt as a unique participant in the primary market for Treasury securities, as evidenced in part by the fact that representatives from the primary dealers would call Bielfeldt to gauge his reaction

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losses against his income from Treasury interest, and he was not able to carry such losses back to earlier years when he realized net gains.

to an upcoming Treasury issuance, and would extend favorable dealer time to Bielfeldt to execute his positions.

B. PROCEEDING BELOW

The Tax Court summarily rejected Bielfeldt's stock in trade argument with the following two sentences:

> To start with, petitioner is incorrect in asserting that his Treasury securities were his stock in trade or inventory, even if he did not hold the securities for sale to customers. As courts have consistently held, securities may be classified as stock in trade or inventory *only when* they are held primarily for sale to customers in the ordinary course of business (emphasis added) (citations omitted).

App. 30. As support for this legal conclusion, the Tax Court cited a series of cases, all of which can be traced back to the decision in *Van Suetendael v. Commissioner*, 152 F.2d 654 (2d Cir. 1945), *aff'g per curiam* 3 T.C.M. (CCH) 987 (1944). App. 30. The remainder of the Tax Court's opinion addressed Bielfeldt's alternative argument that he held the Treasury securities primarily for sale to customers in the ordinary course of his trade or business. The Tax Court concluded that Bielfeldt did not hold his Treasury securities primarily for sale to customers.

In affirming the Tax Court's decision, the Seventh Circuit failed to address the legal issue raised by Bielfeldt in both his opening and reply briefs as to whether a judicial interpretation of 26 U.S.C. § 1221(1) that fails to treat stock in trade as an independent exclusion to the

definition of capital asset violates both the plain meaning of the statute and its legislative history.

On January 8, 2001, the Seventh Circuit denied Petitioners' Petition for Panel Rehearing. App. 48.

C. BASIS FOR FEDERAL JURISDICTION

The Tax Court had jurisdiction to hear the petition in this case pursuant to 26 U.S.C. § 7442. The Seventh Circuit had jurisdiction over the appeal from the Tax Court pursuant to 28 U.S.C. §§ 1291 and 1294 and 26 U.S.C. § 7482.

ARGUMENT (Reasons for Allowance of the Writ)

THIS COURT SHOULD GRANT CERTIORARI TO CORRECT THE SEVENTH CIRCUIT'S FAILURE TO INTERPRET 26 U.S.C. § 1221(1) IN A MANNER CONSISTENT WITH ITS PLAIN MEANING AND LEGISLATIVE HISTORY.

I. The Seventh Circuit's failure to correct the Tax Court's legal conclusion that securities can constitute "stock in trade" under § 1221(1)[10] only if held primarily for sale to customers violates the plain meaning of the statute and basic canons of statutory construction.

Under § 1221(1), the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include:

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[10] Unless otherwise indicated, all subsequent section references are to the Internal Revenue Code of 1986, as amended (26 U.S.C.).

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Based on a plain reading of the statute, § 1221(1) provides for three separate and distinct exclusions from the term "capital asset." Property is excluded from the definition of "capital asset" if it is: (1) stock in trade, *or* (2) *other* property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, *or* (3) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Nothing in this language supports an interpretation that, where the asset in question is a security, the only relevant exclusion is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. The legal conclusion relied on by the Tax Court contradicts the plain meaning of the statute.

By failing to correct or even address the Tax Court's legal conclusion that securities may be classified only as stock in trade or inventory when held primarily for sale to customers in the ordinary course of a trade or business, the Seventh Circuit essentially condoned an interpretation of § 1221(1) that violates a cardinal rule of statutory construction – namely, that, if possible, effect must be given to every clause and part of a statute. Not surprisingly, this rule of statutory construction has been applied to the predecessor of § 1221(1) by the United States Court of Federal Appeals for the First Circuit in

analyzing the character of a loss realized on the disposition of stock. In rejecting an attempt by the Board of Tax Appeals to group the stock in trade exclusion with the exclusion for property held primarily for sale, the First Circuit stated:

> The difficulty with this view is that it gives no effect whatever to the provisions under discussion. It is a well-settled rule of construction that a statute should, if possible, be so construed as to give meaning to all parts of it. *Stock in trade and inventory property having been covered by the first two classifications, the final provision was evidently intended to cover something else.*

Gilbert v. Commissioner, 56 F.2d 361, 362 (1st Cir. 1932) (emphasis added). The Tax Court's construction of § 1221(1) as applied to securities violates this fundamental rule of construction because it essentially deletes the phrase "stock in trade" and "property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year" from the statute.

The Seventh Circuit's deemed acquiescence to the Tax Court's legal conclusion contradicts this Court's approach to statutory construction. "It is our duty 'to give effect, if possible, to every clause and word of a statute,' . . . rather than to emasculate an entire section, as the Government's interpretation requires." *United States v. Menasche*, 348 U.S. 528, 538-39 (1955) (citation omitted); *Ginsberg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932) ("The construction contended for would violate the cardinal rule that, if possible, effect shall be given to every clause and part of a statute."). Earlier this year in

Gitlitz v. Commissioner, 121 S.Ct. 701, 148 L.Ed.2d 613 (2001), this Court reaffirmed its view that tax statutes should be interpreted in a manner consistent with their plain meaning. In *Gitlitz*, the issue before this Court was whether discharge of indebtedness of an insolvent S corporation was an item of income, which passed through to shareholders and increased their basis in the S corporation stock. The Commissioner argued, in part, that the exclusion from gross income under § 108(a)(1) for discharge of indebtedness altered the character of the discharge of indebtedness so that it could no longer be characterized as an "item of income." Based on a plain reading of the statute, the Court found that § 108(a)'s exclusion did not alter the character of discharge of indebtedness as an item of income. As support, the Court stated:

> If discharge of indebtedness of insolvent entities were not actually "income," there would be no need to provide an exception to its inclusion in gross income; quite simply, if discharge of indebtedness of an insolvent entity were not "income," it would necessarily not be included in gross income.

Gitlitz, 121 S.Ct. at 707. Similarly, based on a plain reading of § 1221(1), if stock in trade was not a separate exclusion to the term "capital asset" independent from the exclusion for property held primarily for sale to customers, it would necessarily not be listed separate and apart from the exclusion for property held primarily for sale to customers.

The Seventh Circuit's failure to correct the Tax Court's legal conclusion is even more problematic given

that the Seventh Circuit has itself, on numerous occasions, refused to interpret a statute in a way that fails to give meaning to every word. *See United States v. Obiechie*, 38 F.3d 309, 315 (7th Cir. 1994); *United States v. F.J. Vollmer & Co., Inc.*, 1 F.3d 1511, 1516 (7th Cir. 1993), *cert. denied*, 510 U.S. 1043 (1994); *United States v. Franz*, 886 F.2d 973, 978 (7th Cir. 1989).

II. The Seventh Circuit's failure to correct the Tax Court's legal conclusion that securities can constitute "stock in trade" only if held for sale to customers is contrary to the legislative history of § 1221(1).

The legislative history behind § 1221(1) confirms that stock in trade was intended to be a separate and independent exclusion to the definition of "capital asset." While Congress has amended § 1221(1) and its predecessors numerous times since "stock in trade" was introduced in 1921, Congress has never amended the statute to remove the stock in trade exclusion or to provide that, in the case of securities, the only permissible inquiry under § 1221(1) is whether the securities are held primarily for sale to customers in the ordinary course of a trade or business.

The tax regime for capital assets was first introduced in § 206(a)(6) of the Revenue Act of 1921, which provided that:

> The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held

> for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

Revenue Act of 1921, § 206(a)(6), 42 Stat. 227, 233 (1921). The Revenue Act of 1924 replaced § 206(a)(6) with § 208(a)(8). It kept the stock in trade and inventory categories but added a third category for "property held by the taxpayer primarily for sale in the course of his trade or business." Revenue Act of 1924, § 208(a)(8), 43 Stat. 253, 263 (1924).

Two aspects of the legislative history behind the Revenue Act of 1924 demonstrate the independent importance of the "stock in trade" exclusion. First, the House bill for § 208(a)(8) of the Revenue Act of 1924 proposed to eliminate the inventory category, presumably on the belief that inventory was part of the stock in trade exclusion and that the reference to inventory was superfluous. *See* H.R. No. 6715, § 208(a)(8), 68th Cong., 1st Sess. at 26 (Feb. 7, 1924). The Senate bill proposed to keep both the stock in trade and inventory categories, and the House ultimately agreed to the Senate's version of the bill. In explaining the House's acquiescence on this point, Representative Green of Iowa stated that the inventory reference had been retained:

> to expand a little further the words "stock in trade," as they might possibly be construed to mean just the stock that the merchant or other party happened to hold in his business house at the time, the idea of the committee being that the definition of "capital assets" should exclude

> not only what was in the business house at the time but goods in the process of manufacture and other articles that eventually would become a part of the stock and were held for that purpose, and, therefore, would have to be included in the inventory.

65 Cong. Rec. 2841, 2842 (Feb. 20, 1924). Considered in light of this legislative history, the stock in trade exclusion appears to have been intended as the fundamental exclusion from the definition of "capital asset." As such, the inventory exclusion extends the scope of § 1221(1) to items that might not otherwise qualify as stock in trade but cannot be viewed as a limitation on or a replacement of the stock in trade category.

The second important legislative development in 1924 was the addition of the exclusion for property "held by the taxpayer primarily for sale in the course of his trade or business." The Senate Report accompanying this amendment stated that the provision was added "*to remove any doubt* as to whether property which is held primarily for resale constitutes a capital asset whether or not it is the type of property which under good accounting practice would be included in the inventory." Senate Comm. on Finance, Internal Revenue Bill of 1924, S. Rep. No. 398, 68th Cong., 1st Sess. at 22 (1924), *reprinted in* 1939-1 C.B. (Part 2) 266, 281 (emphasis added). Since the "held primarily for sale" exclusion was enacted to remove any doubt about the status of certain property, it is reasonable to conclude that property held for sale was already excluded from the definition of "capital asset" by reason of the stock in trade exclusion.

In the Revenue Act of 1934, Congress replaced § 208(a)(6) with § 117(b), with one important change. Congress amended the "held for sale" exclusion to read "property held by the taxpayer primarily for sale *to customers* in the *ordinary* course of his trade or business" to further clarify the applicability of the exclusion for property held primarily for sale. Revenue Act of 1934, § 117(b), 48 Stat. 680, 714 (1934) (new language italicized). This language was added to make "it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117." H.R. Conf. Rep. No. 1385, 73d Cong., 2d Sess. at 22 (1934), *reprinted in* 1939-1 C.B. (Part 2) 627, 632. There is no indication in this legislative history that Congress intended for the addition of the words "for customers" or "ordinary" to the exclusion for property held primarily for sale to usurp the exclusion for stock in trade. There is also no support in the legislative history for the view that Congress intended to preclude taxpayers that transact in securities from availing themselves of the stock in trade exclusion. Indeed, the fact that Respondent allows a "stock specialist"[11] who trades for his own account to treat resulting gains or losses as ordinary confirms that stock in trade retains an independent exclusion to the definition of capital asset. *See* Internal Revenue Service Manual Handbook 4232.5, § 420(4) (1976).

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[11] A stock specialist is a member of a market that registers to be a specialist and stands ready to transact in the specialist's own account to assist in the maintenance of a fair and orderly market. *See* Internal Revenue Service Manual Handbook 4232.5, § 420(4) (1976).

The conclusion to be drawn from the legislative history to § 1221(1) is that the stock in trade exclusion is properly viewed as establishing the fundamental exclusion from capital asset status, and the other categories are merely refinements or interpretations of (rather than limitations on) the stock in trade exclusion.

The Tax Court's reliance on *Van Suetendael v. Commissioner*, 152 F.2d 654 (2d. Cir. 1945), *aff'g per curiam* 3 T.C.M. (CCH) 987 (1944), and its progeny for its legal conclusion, is, upon a closer examination, misplaced. In *Van Suetendael*, the taxpayer was a registered securities dealer who bought and sold exchanged-traded securities through brokers. Though unnecessary to its holding, the Tax Court stated:

> The securities which petitioner sold during the taxable years cannot be classified as stock in trade or property subject to inventory in his hands unless they were held by him primarily for sale to customers in the ordinary course of his business. Thus, the issue turns upon whether or not the securities sold by petitioner during the taxable years were held by him *primarily* for sale to customers in the ordinary course of business.

3 T.C.M. at 992. The Tax Court does not cite to any case law or legislative history in support of this statement. The United States Court of Federal Appeals for the Second Circuit upheld the decision of the Tax Court, stating that the issue was predominantly one of fact and that it could not say that the Tax Court's factual conclusions were so unreasonable as to require a reversal of its judgment. *Van*

Suetendael, 152 F.2d at 654. In dictum, the Second Circuit stated:

> [Securities] could not be classified as stock in trade or property subject to inventory unless they were held by the taxpayer primarily for sale to customers in the ordinary course of his business.

Id. Like the Tax Court, the Second Circuit failed to cite any support for this statement of law. Clearly, this dictum cannot form the basis for the legal conclusion favored by the Tax Court and condoned by the Seventh Circuit in this case because it violates both the plain meaning of § 1221(1) and its legislative history. There is simply no legislative indication that stock in trade is not an independent exclusion from the definition of the term capital asset.

III. As a result of the Seventh Circuit's failure to correct the Tax Court's stock in trade analysis, the Seventh Circuit has created a direct and irreconcilable conflict between itself and this Court.

Issuance of a writ of certiorari is compelling in this case because the proper statutory construction of the exclusions under § 1221(1) is an important question to the administration of the federal tax law. By endorsing the legal conclusion of the Tax Court, the Seventh Circuit has impermissibly exceeded the scope of its judicial authority to interpret, not create the laws. In so doing, the Seventh Circuit's decision creates a direct and irreconcilable conflict between the Seventh Circuit and the specific decisions of this Court in *Arkansas Best Corp. v. Commissioner*,

485 U.S. 212 (1988), and *Corn Products Ref. Co. v. Commissioner*, 350 U.S. 46 (1955).

The statutory interpretation offered by the Tax Court and implicitly upheld by the Seventh Circuit creates a direct conflict with this Court's holding in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). In *Arkansas Best*, one of the petitioner's contentions was that the (then) five exceptions listed in § 1221 (*i.e.*, § 1221(1)-(5)) were illustrative, rather than exhaustive, and that courts were free to fashion additional exceptions based on business-motive in order to further the general purposes of § 1221. Rejecting this argument, this Court stated:

> Petitioner's reading of the statute is also in tension with the exceptions listed in § 1221. These exclusions would be largely superfluous if assets acquired primarily or exclusively for business purposes were not capital assets. Inventory, real or depreciable property used in the taxpayer's trade or business, and accounts or notes receivable acquired in the ordinary course of business, would undoubtedly satisfy such a business-motive test. Yet these exceptions were created by Congress in separate enactments spanning 30 years. Without any express direction from Congress, we are unwilling to read § 1221 in a manner that makes surplusage of these statutory exclusions.

Id. at 218 (citations omitted). By condoning an interpretation of § 1221 that clearly makes surplusage of the stock in trade exclusion, the Seventh Circuit directly contradicts this Court's directive in interpreting § 1221's exclusions.

While *Arkansas Best* dealt with the interplay between different sections of § 1221, this Court has also specifically recognized the three separate exclusions under § 1221(1). In *Corn Products Ref. Co. v. Commissioner*, 350 U.S. 46 (1955), this Court, in testing whether the taxpayer's corn futures came within the literal language of the predecessor to § 1221(1), stated, "[the corn futures] were not *stock in trade*, actual inventory, *property held for sale to customers or* depreciable property used in a trade or business." *Id.* at 51-52 (emphasis added). The importance of this analysis is that this Court tested the asset in question as both stock in trade and as property held for sale to customers.

THIS COURT SHOULD GRANT CERTIORARI BECAUSE OF THE IMPORTANCE OF THIS ISSUE TO THE EFFICIENT FUNCTIONING OF THE TREASURY CASH MARKET.

I. The tax treatment of recognized market makers in Treasury securities is an important issue because of the vital role these taxpayers play in ensuring the efficient distribution of Treasury securities at the lowest possible cost to the Government.

Issuance of a writ of certiorari is compelling in this case because of the possible impact of the Seventh Circuit's decision to the vital role that market makers, like Bielfeldt, play in ensuring the efficient working of the Treasury cash market. By upholding the Tax Court's distinction between primary dealers and market makers (like Bielfeldt) for purposes of § 1221(1), the Seventh Circuit's decision may create a disincentive for market

makers in the Treasury cash market, and raise the overall cost of government financing.

The Federal Reserve's primary public purpose is to satisfy the large financing needs of the federal government and its agencies in a cost-effective manner.[12] To ensure the lowest possible financing costs, the Treasury encourages bids from active participants to (1) help set the price of an upcoming auction issuance through when-issued trading, and (2) distribute the Treasury securities to the market following the auction. As recognized by the federal government, when-issued trading plays an important role by "serving a price discovery function and by stretching out the actual distribution period for each issue, thereby allowing the market more time to absorb large issues without disruption."[13] Any disruption to the Treasury cash market's liquidity that increases the government's financing costs by as little as one basis point (one hundredth of one percentage point) could cost the taxpayers over $300 million each year.[14]

The contribution of market makers to the efficient working of the primary market for Treasury securities is undisputed. It is also uncontested that Bielfeldt's participation contributed substantially to the efficiency and liquidity of the Treasury securities market during a period of exploding deficits and likely lowered the overall cost of Treasury financing. By failing to recognize a distinction between a specialist's "stock in trade" and property held

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[12] Joint Report, *supra* n. 4, at 1.

[13] *Id.* at 9.

[14] *Id.* at 3.

primarily for sale to customers in the ordinary course of business, the Seventh Circuit's decision could have a chilling effect on market makers, and, indirectly, burden the Treasury and U.S. taxpayers. Market makers like Bielfeldt, who engage principally in proprietary trading of Treasury securities in the primary market, may choose to reduce their involvement given the standard imposed by the Tax Court and upheld by the Seventh Circuit. That standard, if upheld, provides that taxpayers involved in Treasury securities can only recognize ordinary gain and loss if they can establish that they hold those securities primarily for sale to customers, a standard (under the Tax Court's opinion) virtually impossible to satisfy in the primary market for Treasury securities.

CONCLUSION

For the reasons set forth above, certiorari should be issued to the United States Court of Federal Appeals for the Seventh Circuit so that this honorable Court may review and correct the decision below.

Respectfully submitted,

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April 6, 2001

In The
United States Court of Appeals
for the Seventh Circuit.

No. 00-1747

GARY K. BIELFELDT and CARLOTTA J. BIELFELDT,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Petition to Review Decision
of the United States Tax Court.
No. 5936-96 – **David Laro**, *Judge.*

ARGUED September 27, 2000 – DECIDED November 8, 2000

Before POSNER, COFFEY, and KANNE, *Circuit Judges.*

POSNER, *Circuit Judge.* Gary Bielfeldt (and his wife, but she is a party only by virtue of having filed a joint return with her husband), a large trader in U.S. Treasury notes and bonds, seeks to overturn a decision by the Tax Court denying him the right to offset immense trading losses that he incurred in the 1980s against all but $3,000 a year in ordinary income. He claims to be not a trader but a dealer and that the losses he incurred in the sale of the Treasury securities were losses connected with his

dealer's "stock in trade"; such losses, even when they result as his did from the sale of a capital asset, are treated as ordinary rather than capital losses and can therefore be fully offset against ordinary income. 26 U.S.C. § 1221(1). In contrast, capital losses, while they can be fully offset against capital gains, can be offset against ordinary income only up to $3,000 a year. 26 U.S.C. § 1211(b); *Marrin v. IRS*, 147 F.3d 147, 150-52 (2d Cir. 1998). Although the amount is arbitrary, the rationale for limiting such offsets is not; it is to reduce taxpayers' incentives to so structure their capital transactions as to realize losses today and defer gains to the future. See Robert H. Scarborough, "Risk, Diversification, and the Design of Loss Limitations Under a Realization-Based Income Tax," 48 *Tax L. Rev.* 677, 680-81 (1993); Alvin C. Warren, Jr., "The Deductibility by Individuals of Capital Losses Under the Federal Income Tax," 40 *U. Chi. L. Rev.* 291, 310-14 (1973). If Bielfeldt's characterization of his status is sound, he is entitled to some $85 million in refunds of his federal income tax.

The standard distinction between a dealer and a trader is that the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely, fluctuations in the market value of the securities or other assets that he transacts in. *Marrin v. IRS*, *supra*, 147 F.3d at 151; *United States v. Wood*, 943 F.2d 1048, 1051-52 (9th Cir. 1991); *United States v. Diamond*, 788 F.2d 1025, 1029 (4th Cir. 1986). This is not to deny that a trader, whether he is

a speculator, a hedger, or an arbitrageur, serves the financial system by tending through his activities to bring prices closer to underlying values, by supplying liquidity, and by satisfying different preferences with regard to risk; he is not a parasite, as the communists believed. But he is not paid for these services. His income from trading depends on changes in the market value of his securities between the time he acquired them and the time he sells them.

Although one thinks of a dealer's inventory or stock in trade as made up of physical assets, it can be made up of securities instead. A stockbroker who owned shares that he sold to his customers at market price plus a commission would be a bona fide dealer. The example of a recognized "dealer" in securities that is closest to Bielfeldt's self-description because it blurs the distinction between deriving income from providing a service in the purchase or sale of an asset and deriving income from changes in the market value of an asset is a floor specialist on one of the stock exchanges. The specialist maintains an inventory in a specified stock in order to maintain liquidity. If its price soars, indicating that demand is outrunning supply, he sells from his inventory to meet the additional demand, and if the price of the stock plunges, he buys in the open market in order to provide a market for the people who are trying to sell. See *Bradford v. United States*, 444 F.2d 1133, 1135 (Ct. Claims 1971) (per curiam); Louis Loss, *Fundamentals of Securities Regulation* 671, 792-93 (1983); Zvi Bodie, Alex Kane & Alan J. Marcus, *Investments* 89-91 (3d ed. 1996). He is not paid by the stock market for this service, but is compensated by the income he makes from his purchase and sales and by

commissions on limit orders (orders contingent on a stock's price hitting a specified level) placed with him by brokers. *United States v. Bleznak*, 153 F.3d 16, 18 (2d Cir. 1998); *Fridrich v. Bradford*, 542 F.2d 307, 309 n. 5 (6th Cir. 1976); Loss, *supra*, at 671; Bodie, Kane & Marcus, *supra*, at 90. The Internal Revenue Service treats his gains and losses as ordinary income because the Internal Revenue Code classifies him as a dealer. See 26 U.S.C. §§ 1236(a), (d).

Treasury securities, at least the ones in which Bielfeldt transacted, are not sold on an organized exchange, and so there are no floor specialists – there is no floor. The market for Treasury securities is an over-the-counter market, like the NASDAQ. But the economic function that the specialists on the organized exchanges perform is independent of the form of the market, and dealers who specialize in Treasury securities (called "primary dealers," and discussed in the next paragraph) are close analogues of the floor specialists, just as NASD market makers are. There is even a new law that requires the primary dealers in Treasury securities, with some exceptions, to register with the SEC or the NASD. Government Securities Act of 1986, Pub. L. 99-571, §§ 102(e) and (f), 100 Stat. 3218, 15 U.S.C. § 78o-5.

Bielfeldt claims that he performs this function too, though he is not a registered or primary dealer. The securities in question are used to finance the national debt. During the period in which he incurred losses, there was no talk of paying off the debt – on the contrary, the debt was growing. To finance growth and redemptions, the Treasury would periodically auction large quantities of bonds and notes, which would be underwritten by a

relative handful of primary dealers. Bielfeldt would buy in huge quantities from these dealers and resell in smaller batches, often to the same dealers, a few weeks later. His theory, which worked well for a few years and then turned sour, was that the Treasury auctions were so large that each one would create a temporary glut of Treasury securities, driving price down. He would buy at the depressed price and hold the securities off the market until, the glut having disappeared (because he was hoarding the securities), price rose, and then he would sell. He argues that had it not been for this service that he performed in the marketing of Treasury securities, the price the Treasury got at its auctions would have been depressed, with the result that interest on the national debt would be even higher than it is.

What he is describing is simply the social benefit of speculation. Think back to the Biblical story of Joseph. During the seven fat years, years of glut, Joseph "hoarded" foodstuffs so that there would be an adequate supply in the seven lean years that he correctly predicted would follow. In a money economy, he would have financed the program by buying cheap, which would be easy to do in a period of glut, and selling dear, which would be easy to do in a period of scarcity and would help to ration supplies in that period. He would buy cheap yet pay higher prices than people who were buying for consumption, since he would anticipate a profit from the later sale during the period of scarcity. Similarly, Bielfeldt hoarded Treasury securities during the fat weeks immediately after an auction so that there would be an adequate supply in the lean weeks (the weeks between auctions) that followed. That activity may have been

socially beneficial, as he argues, but it is no different from the social benefits of speculation generally. His argument if accepted would turn every speculator into a dealer for purposes of the Internal Revenue Code. *United States v. Diamond*, 788 F.2d 1025, 1030 (4th Cir. 1986).

Unlike a floor specialist, Bielfeldt undertook no obligation to maintain an orderly market in Treasury securities. He did not maintain an inventory of securities; and because he skipped auctions that didn't seem likely to produce the glut that was the basis of his speculative profits, there were months on end in which he could not have provided liquidity by selling from inventory because he had no Treasury securities. In some of the tax years in question he participated in as a few as 6 percent of the auctions, and never did he participate in more than 15 percent. As a result, he was out of the market for as much as 200 days a year. He was a speculator, period. As the Federal Reserve Bank of New York, which kept track of Bielfeldt's trading in Treasury securities and sent updates to the IRS, put it, "his activities are in most cases outright speculation on interest rate movements."

In saying that Bielfeldt was not a specialist, we don't mean to imply that the Internal Revenue Service would be required to recognize as a dealer a trader who structured his operation to resemble that of a floor specialist but was not a floor specialist as defined in 26 U.S.C. § 1236(d)(2). That issue is not before us. Nor is the bearing of a 1997 statute, 26 U.S.C. § 475(f), which allows a securities trader to treat paper gains and losses as ordinary rather than capital income by marking to market the securities he owns at the end of the tax year, that is, by pretending they had been sold then. We note finally that

Bielfeldt's alternative argument, that Treasury securities are "notes receivable acquired in the ordinary course of trade or business" and therefore are not capital assets within the meaning of 26 U.S.C. § 1221(4), is frivolous. It implies that no bonds, government or private, are capital assets, since a bond, like a note receivable, is a promise to pay the holder of the instrument.

AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

T.C. Memo. 1998-394

UNITED STATES TAX COURT

GARY K. BIELFELDT AND CARLOTTA J. BIELFELDT, ET AL.,[1] Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Filed November 6, 1998.

Docket Nos. 5936-96, 6080-96, 6154-96, 6155-96, 6156-96, 7264-96, 7265-96, 7346-96.

Timothy C. Frautschi, Maureen A. McGinnity, Elizabeth Staton Idleman, Lloyd J. Dickinson, and *Wayman C. Lawrence, IV,* for petitioners.

Alan M. Jacobson, Joseph T. Ferrick, and *David D. Choi,* for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

LARO, *Judge:* Gary K. Bielfeldt and Carlotta J. Bielfeldt petitioned the Court to redetermine respondent's determination of deficiencies in, and additions to,

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[1] Cases of the following petitioners have been consolidated for purposes of trial, briefing, and opinion: docket No. 6080-96, Bielfeldt & Company Profit Sharing Plan and Trust, Bank One, Peoria, Trustee, and Bielfeldt & Company, a general partnership; by Gary K. Bielfeldt; docket No. 6154-96, Linda S. Bielfeldt; docket No. 6155-96, David L. & Julie K. Bielfeldt; docket No. 6156-96, Karen J. Bielfeldt Gray; docket No. 7264-96, Gary K. & Carlotta J. Bielfeldt; docket No. 7265-96, Gary K. Bielfeldt; docket No. 7346-96, David L. & Julie K. Bielfeldt. After trial, however, the parties notified the Court that the issue addressed herein applies only to docket No. 5936-96. Accordingly, the issue addressed herein applies only to docket No. 5936-96.

their 1984 through 1988 Federal income taxes. Respondent determined the following deficiencies and additions thereto:

		Additions to Tax	
Year	Deficiency	Sec. 6653(a)(1)	Sec. 6661
1984	–	$ 32,514	–
1985	$ 5,013,651	1,280,929	$1,253,413
1986	19,342,834	967,142	4,835,709
1987	6,871,323	343,566	1,717,831
1988	2,523,008	126,150	630,752

Respondent also determined that petitioners are liable for the time-sensitive addition to tax under section 6653(a)(2) for each of the taxable years from 1984 through 1987.

Following the trial of one of the issues arising in this case, we must decide whether gains and losses realized by Gary K. Bielfeldt (petitioner) on the disposition of U.S. Treasury securities (Treasury securities) are ordinary or capital. We hold they are capital. Unless otherwise stated, section references are to the Internal Revenue Code in effect for the relevant years.

FINDINGS OF FACT

I. Overview

Some facts have been stipulated and are so found. The stipulated facts and exhibits submitted therewith are incorporated herein by this reference. Petitioner and Ms. Bielfeldt are husband and wife, and they resided in Peoria Heights, Illinois, when they petitioned the Court. They are cash method taxpayers, and they filed joint Federal income tax returns for the subject years. Their

1984 through 1988 tax returns were prepared by Peat, Marwick, Mitchell & Co., or a successor thereto (collectively, Peat, Marwick). Their 1989 return was prepared by Coopers & Lybrand. Petitioner holds a bachelor's degree and a master's degree.

During the subject years, petitioner bought and sold Treasury securities, and his tax returns for those years reported his sales as capital gains or capital losses. Petitioner's 1984 return reported that he was an "investor" in Treasury securities. Petitioner's 1985 through 1989 returns reported that he was a "trader" in Treasury securities. Petitioner notified respondent of his claimed change in status by attaching a statement to his 1985 tax return that read in relevant part as follows:

> During 1985 the above-named taxpayer had a very extreme change in the volume of trading activities conducted on his own behalf. The magnitude of trading activities now qualify the taxpayer as "trader" for tax purposes rather than an "investor".

Respondent audited petitioner's 1984 through 1989 taxable years, and, at or about the same time, respondent audited the related years of Bielfeldt & Co. (B & C) and its predecessor Bielfeldt, Lauritsen & Hagemeyer (BL & H), general partnerships in which petitioner was the controlling partner.[2] Respondent's audit of petitioner ended

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[2] BL & H's partnership agreement was amended on Dec. 7, 1985, to change BL & H's name to B & C as of Jan. 1, 1986. Both BL & H and B & C filed Forms 1065, U.S. Partnership Return of Income. Hereinafter, we refer to BL & H as B & C.

on April 22, 1991, with the issuance to him of a 30-day letter.

On July 17, 1991, petitioner amended his 1985 through 1988 tax returns to assert therein that he was a dealer in Treasury securities, and that he was entitled to income tax refunds resulting from reclassifying his gains and losses as ordinary. On January 11, 1996, respondent issued to petitioner a notice of deficiency that, in relevant part, disallowed the refund claims on the amended returns on the basis of respondent's determination that petitioner was not a dealer in Treasury securities. In this proceeding, petitioner claims the following income tax refunds on the basis of his assertion that he was a dealer:

Year	Refund
1984	$ 3,202,380
1985	19,781,480
1986	39,160,798
1987	16,232,812
1988	6,658,075

II. Treasury Securities Cash Market

The Treasury securities cash market consists of bills, notes, and bonds issued by the Department of the Treasury (Treasury). Treasury bills (T-bills) are issued in 3-month, 6-month, or 1-year maturities. T-bills are non-interest-bearing obligations that are issued below face value and redeemed at maturity at face value. Treasury notes (T-notes) are issued in 2-, 3-, 4-, 5-, 7-, or 10-year maturities. T-notes are issued at or near face value, and they are redeemed at maturity at face value. T-notes bear a fixed rate of interest, which is payable semiannually,

and most T-notes are noncertificated; i.e., they do not exist in physical form but trade through an electronic system known as the Federal Reserve Bank book entry system. Treasury bonds (T-bonds) mature 10 or more years after issuance. T-bonds are issued at or near face value, and they are redeemed at maturity at face value. T-bonds bear interest, which is payable semiannually, and most new T-bonds are noncertificated. The interest rate on new T-bonds is set at auctions held by the Federal Reserve Bank of New York (the Fed).

Treasury securities are rarely listed on an organized exchange, and the volume of trading of Treasury securities on organized exchanges is minimal. Virtually all trading of Treasury securities occurs over the counter or at auctions which the Treasury holds to sell the securities initially. Auction bidders tender competitive or noncompetitive bids. Competitive bids generally represent the price that bidders offer to buy the securities, and noncompetitive bids generally represent the bidders' offers to buy the securities at the average of the successful competitive bids. Bidders, other than primary dealers (as defined below), must deposit 10 percent of any competitive bid tendered, and these deposits are held without interest for days or weeks until the auction purchase settles. In practice, only primary dealers submit competitive bids directly to the Treasury; they do so for their own accounts as well as on behalf of others.

After Treasury securities are issued through the auction process, they are generally traded over the counter in direct transactions between the buyer and the seller or

through interdealer brokers (as defined below).[3] Prices are quoted as bids (the price that a buyer is willing to pay) and offers or asks (the price at which a seller is willing to sell). A transaction is effectuated when a buyer or seller accepts a bid or offer, respectively, or when they negotiate a different price. Over-the-counter trading of Treasury securities is usually effectuated over the telephone on the basis of established business relationships.

"Primary dealers" are the 35 to 40 firms which have been recognized as such by the Fed to deal with it directly in the Treasury securities market.[4] In designating primary dealers, the Fed applies the following criteria: (1) The firm must have adequate capital relative to the positions it assumes; (2) the firm must participate consistently and meaningfully in Treasury auctions of new securities and must submit bids in every auction; (3) the firm must file periodic reports with the Fed setting forth certain market information; and (4) the firm must be an effective market maker.

Primary dealers trade Treasury securities for their own accounts (proprietary trading) or for the accounts of customers pursuant to customer directives (customer

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[3] Between the announcement of an upcoming auction and the issuance of the securities following the auction, new issues of Treasury securities also are traded over the counter on a "when-issued" (WI) basis for a period that may last from several days to approximately 2 weeks. The purchaser of WI securities must pay for the securities on or before the date that the securities are issued.

[4] Dealers in the Treasury securities market who are not primary dealers are known informally as "secondary dealers". The Treasury securities market has many secondary dealers.

trading). These two types of trading are not mutually exclusive. A primary dealer may accept a customer's bid or offer for a particular security as part of the dealer's proprietary trading strategy, or it may initiate trades to improve its proprietary position. Primary dealers frequently trade Treasury securities with other primary dealers either directly (trader to trader) or indirectly through interdealer brokers. Primary dealers frequently sell to other primary dealers the Treasury securities that they purchase at auction. When a primary dealer and a counterparty agree on a transaction, a trade ticket is prepared which states the terms of the transaction. The primary dealer uses the information on the trade ticket to prepare a confirmation slip that is sent to the counterparty.

Interdealer brokers are brokerage firms that facilitate trades between counterparties who are mainly primary dealers; interdealer brokers do not hold positions in Government securities themselves. The principal interdealer brokers are RMJ, Fundamental Brokers, Inc., Garban, Liberty, and Cantor Fitzgerald (CF). CF is the only interdealer broker that trades for customers other than primary dealers. CF's customers include banks, fund managers, and investment funds. Approximately 30 percent of CF's volume of trading in Treasury securities is for customers who are not primary dealers.

Interdealer brokers provide their customers with CRT terminals (screens) on which the customers may view in their offices the best bids and offers made by the broker's subscribers. The customers telephone bids and offers to their broker, and the broker electronically posts these bids and offers on its screens without identifying the

customers who are tendering the bids or offers.[5] When a person accepts a bid or an offer listed with the broker, the broker effectuates the transaction and indicates on its screens that the bid or offer was accepted. The broker sends confirmation to the buyer and seller showing the broker itself as the counterparty; neither the person quoting the price nor the person accepting the price knows the identity of the counterparty.[6] The broker earns a commission, which is paid by the person who accepted the bid or offer.

III. Financing Positions in Treasury Securities

Treasury securities are excellent collateral for loans because they are highly liquid. Loans secured by Treasury securities usually take the form of a simultaneous "sale" of the security by the borrower to the lender and a binding obligation of the borrower to "repurchase" the security from the lender in the future at a somewhat higher price than the original sale price.[7] The difference between the purchase and sale prices is the functional equivalent of interest. A borrower calls these transactions "repurchase agreements" or "repos", and a lender calls these transactions "reverse repurchase agreements" or

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[5] Bids and offers are also quoted directly (verbally or otherwise) between potential counterparties.

[6] For this reason, interdealer brokers are known as "blind brokers".

[7] Although the "loans" are actually independent purchase and sale transactions, the terms "borrower" and "lender" are used figuratively to simplify the explanation of these financing arrangements.

"reverse repos". A reverse repo allows a person with idle cash to earn interest on the idle funds, and it allows a seller of unencumbered Treasury securities to finance a counterparty's purchase of securities. A reverse repo also lets a short seller of Treasury securities borrow the securities to cover a short sale; cash is transferred to the security lender as collateral to guarantee return of the borrowed security, and the short seller earns interest on the cash collateral. The lender under a repo typically buys and resells the Treasury security at a small discount from its current value.

Repos can mature overnight, they can have fixed, longer terms, or they can have indefinite terms that continue until terminated by either party. The interest rate charged by a repo lender can be fixed for the term of the repo, or it can be reset daily.

Repurchase and reverse repurchase transactions are primarily transacted over the telephone, and primary dealers, secondary dealers, interdealer brokers, and other market participants engage in repos and reverse repos as principals. The Treasury securities cash market is characterized by highly leveraged transactions, and virtually all participants in the Treasury securities market engage in leveraged trading to a large extent.

IV. Background of Petitioner and B & C

Petitioner has worked in the commodities and securities industries his entire career. From 1960 to 1970, he worked as a securities broker registered with the National Association of Securities Dealers (NASD), the New York Stock Exchange, and the American Stock

Exchange. From 1970 to 1972, he worked with J.W. Dickson, a Futures Commission Merchant (FCM) and a member of the Chicago Board of Trade (CBT).[8] In 1972, he began working for B & C, a commodities clearing firm that he formed in partnership with three former coworkers. Petitioner was B & C's managing partner, and he initially owned 54 percent of its equity. B & C traded commodity futures for its own account and for the accounts of its customers, and it cleared trades for customers with accounts which it managed on a nondiscretionary basis (nondiscretionary accounts).[9] B & C was a member of the CBT and the Board of Trade Clearing Corporation. B & C was registered with the CFTC as an FCM.

At the end of 1982, petitioner purchased his partners' interests in B & C, and he installed his three children as partners as of January 1, 1983. As relevant herein, petitioner owned 95.5 percent of B & C, and each of his children owned 1.5 percent. B & C traded Treasury securities in both the cash and futures markets for customer accounts and for its own accounts, and it had established trading relationships and credit lines with a number of primary and secondary dealers. B & C facilitated retail customers' submittal of noncompetitive bids in Treasury auctions by forwarding their bids to a primary dealer

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[8] An FCM is a designation given by the Commodity Futures Trading Commission (CFTC) to a person who it has licensed to do business in the futures market.

[9] Alternatively, an account could be managed on a discretionary basis. In the case of discretionary accounts, customers give their broker a set amount of money to manage in the manner which the broker believes is wise.

named Harris Bank & Trust. B & C acted on behalf of the retail customers in reselling the securities purchased at auction at the highest available price. B & C's retail customers in Treasury securities were long-term clients, personal friends, employees, and friends of personal friends. The only account holders at B & C, other than petitioner, who traded Government securities were customers of B & C, not of petitioner.

B & C's offices are in Peoria and Chicago, Illinois, and employees in both offices engage in proprietary trading. The Peoria office is primarily responsible for customer relations, including identifying and soliciting customer prospects, preparing customer account agreements, responding to customer inquiries, and administering the managed account program. The Chicago office serves "back office" functions, clearing all Treasury securities, futures, and other trades and handling accounting, customer credit, and regulatory compliance. Petitioner works out of the Peoria office, and B & C pays the rent on the space that he uses. Petitioner used this space to engage in his personal trading, which included the trading of futures contracts, stocks, corporate bonds, and all three types of Treasury securities. Petitioner transacted his personal trades through B & C, and B & C cleared these trades and performed the required bookkeeping for them. Petitioner used B & C's video screens and other market information services to assist him with his Treasury securities cash trading, and he used B & C's telephones and direct lines to primary dealers. An employee in the Peoria office arranged financing for petitioner's Treasury securities trades.

Petitioner's personal trading was transacted through B & C's House Account 2900 (Account 2900). B & C maintained this account as a "partner's account", and the securities purchased and sold in Account 2900 were petitioner's property. Petitioner did not share with his partners the gains and losses from trading these securities, and he made his own trading decisions in trading in this account. The typical holding period for the Treasury securities held in Account 2900 was less than 1 month.

Petitioner's trading records were maintained primarily in the Peoria office by B & C employees; B & C's records were maintained in the Chicago office. B & C employees in Peoria forwarded clearing instructions to the Chicago office for all of petitioner's Account 2900 trades, and B & C employees in the Chicago office cleared all these trades and made appropriate entries in B & C's records.

The Government Securities Act of 1986 (the 1986 Act), Pub. L. 99-571, sec. 102(e) and (f), 100 Stat. 3218, 15 U.S.C. sec. 78o, became effective in July 1987. Before that time, most dealers in Treasury securities were not required to register with the Securities and Exchange Commission (SEC) or the NASD. The 1986 Act required Government securities brokers and dealers to register with the SEC and the NASD unless an exemption applied. Initially, there was uncertainty as to whether the 1986 Act required firms like B & C, already registered with and regulated by the CFTC as an FCM, to register with the SEC and the NASD. B & C initially applied for registration but later withdrew its application on the basis of its understanding that it was not required to register because it was an FCM. Petitioner, who was not

personally registered as an FCM, never registered with the SEC as a Government securities dealer for a trade or business separate from B & C's, and he never registered with the NASD as a dealer for a trade or business separate from B & C's.

Generally, any person acting as a dealer in securities and maintaining a place of business in Illinois must register with the Illinois secretary of state. B & C did not register with the Illinois secretary of state because of its understanding that it was exempt from registration requirements as an FCM. Petitioner never registered with the Illinois secretary of state as a dealer for a trade or business separate from B & C's.

V. Petitioner/B & C Trading in Treasury Securities Cash Market

Petitioner traded Treasury securities through Account 2900 with the following known counterparties:

Aubrey G. Lanston & Co., Chicago
Barclays de Zoete Wedd, New York
Chemical Bank, New York
Chicago Research & Trading Co., New York
Citibank, N.A./Citicorp, New York
Continental Illinois National Bank and Trust Co., Chicago
Daiwa Securities America, Inc., New York
Discount Corp. of New York
Drexel Burnham Lambert Government Securities, Inc., New York
* Fidelity Investments Brokerage Services, Boston
First Boston Corporation, New York

First Interstate Bank of California, Chicago
Goldman, Sachs & Co., New York
Greenwich Capital Markets, Inc., Greenwich, CT
Harris Trust & Savings Bank, Chicago
Kidder Peabody & Co., Incorporated, Chicago
Kleinwort Benson Government Securities, Chicago
Lehman Government Securities, Inc., New York
Lloyds Government Securities, Inc., New York
Manufacturers Hanover Trust Co., New York
Merrill Lynch Government Securities, New York
Morgan Stanley & Co., Inc., New York
Nomura Securities International Inc., New York
Salomon Brothers Inc., New York
Smith Barney Government Securities, Inc., Chicago
* Staley Financial Services Inc., New York
Yamaichi International American Inc., New York

All of these counterparties, other than the two denoted with an asterisk, were or became primary dealers during the subject years. Petitioner regularly purchased securities from and sold securities to, and engaged in repos and reverse repo transactions with, these counterparties. These transactions were effectuated through Account 2900. Petitioner traded Treasury securities in Account 2900 directly with these counterparties on a principal-to-principal basis. He also traded Treasury

securities in Account 2900 with other, unknown counterparties (i.e., on a blind basis) through CF. He regularly dealt with many different counterparties to improve his access to market information. He traded mainly with large primary dealers because they were among the most active participants in the Treasury securities cash market, and they traded the largest volumes.

Before 1985, B & C opened an account with CF. CF provided B & C with its Speed System electronic screen; B & C already had two screens. Through CF, petitioner posted bids and asks on these screens and executed blind trades with counterparties who were either primary dealers or other market participants. Petitioner could not place orders to buy or sell securities on any other interdealer broker screen because those screens were restricted for use by primary dealers only. CF gave petitioner the same favorable commission rate extended to primary dealers on account of the volume of his trading. The advantageous commission rate offered to petitioner, based on volume, was generally available to all CF customers.

Petitioner worked an average of 12 hours per day, spending 60-80 percent of his time trading in Account 2900. His trading assistant, a B & C employee named Cindy James, verbally confirmed all of his Account 2900 trades with his counterparties on the day of the trade, and, during the next day, she verified principal and accrued interest and prepared the necessary cash and security delivery instructions. Although it was customary for dealers to send their customers confirmation, petitioner did not send confirmation to his counterparties.

Petitioner traded the following dollar volumes in the Treasury securities cash market during 1985 through 1989:

COUNTERPARTY	1985	1986	1987	1988	1989
Aubrey Lanston	-0-	-0-	-0-	-0-	$50,000,000
Barclays Bank	-0-	-0-	-0-	-0-	150,000,000
CF[1]	$6,668,145,000	$15,757,000,000	$1,427,000,000	$1,828,000,000	9,547,000,000
Chemical Bank	-0-	-0-	50,000,000	55,000,000	200,000,000
Chicago Research & Trading	-0-	1,808,000,000	-0-	-0-	535,000,000
Citibank	-0-	-0-	294,000,000	-0-	4,348,000,000
Continental Bank	-0-	-0-	-0-	-0-	636,000,000
Daiwa	-0-	150,000,000	-0-	-0-	139,000,000
Discount Corp.	50,000,000	1,415,000,000	200,000,000	70,000,000	485,000,000
Drexel Burnham	1,872,600,000	4,348,000,000	934,500,000	-0-	550,000,000
Fidelity	-0-	-0-	-0-	-0-	200,000,000
First Boston	3,686,550,000	3,298,000,000	105,000,000	-0-	150,000,000
First Interstate	2,330,000,000	2,712,800,000	400,000,000	-0-	-0-
Goldman Sachs	12,761,645,000	12,134,750,000	7,777,000,000	12,291,000,000	2,368,000,000
Greenwich Capital	-0-	-0-	-0-	-0-	2,010,000,000
Harris Bank	1,357,000,000	108,000,000	10,000,000	907,000,000	2,482,000,000
Kidder Peabody	-0-	410,000,000	575,000,000	-0-	50,000,000
Kleinwort Benson	494,000,000	-0-	-0-	-0-	100,000,000
Lehman Brothers	912,000,000	2,167,800,000	480,000,000	55,000,000	3,126,000,000
Lloyds	-0-	468,000,000	-0-	-0-	-0-
Manufacturers	-0-	630,000,000	-0-	-0-	-0-
Merrill Lynch	4,853,250,000	3,073,000,000	305,800,000	125,000,000	1,057,000,000
Morgan Stanley	-0-	150,000,000	-0-	-0-	-0-
Nomura	-0-	615,000,000	100,000,000	-0-	-0-
Salomon Bros.	10,073,000,000	69,169,750,000	8,869,500,000	3,107,000,000	9,829,000,000
Smith Barney	-0-	-0-	-0-	-0-	250,000,000
Staley	50,000,000	-0-	-0-	-0-	-0-
Yamaichi	-0-	215,000,000	-0-	-0-	-0-
Total	145,108,190,000	118,630,100,000	21,527,800,000	18,438,000,000	38,262,000,000

[1] These volumes refer to trades brokered by CF on a blind basis.

Dealers try to be available regularly to satisfy customer requests, and the normal function of a Government securities trading desk at a primary dealer is to try to buy and sell securities all the time. Primary dealers typically engage in Government securities trading daily, and they seldom fail to respond to a customer request to do a transaction or to make a market.[10] No person ever asked petitioner to make a market, and petitioner did not always accept requests to buy or sell a security. Petitioner was more interested in buying an initial position rather than selling. He had no Government securities transactions during extended periods during the subject years; his trading gaps exceeded 100 days in 1987, 150 days in 1988, and 200 days in 1989. He did not trade on a regular daily basis during 1987, 1988, and 1989, and he suffered increasing losses in those years.

The Treasury holds 157 Treasury securities auctions each year, most of which are weekly auctions of Treasury bills. Petitioner was awarded Treasury securities in 23 auctions in 1985, 19 in 1986, 14 in 1987, 9 in 1988, and 9 in 1989. Petitioner's auction purchases as a percentage of his total purchases of Treasury securities ranged from 25 to 50 percent during 1985 through 1989. Overall, petitioner acquired more than one-third of his Treasury securities through auctions during that period. Petitioner participated actively in the auctions because they allowed him to acquire a large position in a short time at one price. Petitioner then traded from the core positions acquired at auction, adding to his holdings through purchases and

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[10] Making a market means providing a simultaneous bid and offer on the same security pursuant to a customer request.

selling the securities to primary dealers in smaller blocks. Petitioner frequently submitted multiple bids in the same auction through different primary dealers. Petitioner never acquired a Treasury security on the auction in response to a prospective buyer's request to repurchase that security from him.

Petitioner had ongoing contacts with CF and numerous primary dealers. There was no difference in the way CF treated petitioner and the way it treated any other CF customer. When a customer of CF would call to place a bid or offer on the CF system, it was solely the customer's choice to decide the security on which he would make a bid or offer. When petitioner called CF to post a bid or offer on the CF system, it was solely his choice whether to do so, and solely his choice as to the specific security he wanted to bid or offer. When petitioner called CF to post a bid or offer on the CF system, it was not pursuant to a request by a customer of petitioner to do a trade. Many times petitioner would submit a bid to CF and ask that it be continuously re-input into the CF system until petitioner was successful in buying the desired security. Petitioner on occasion gave discretion to primary dealers as to price for both auction and nonauction transactions. On other occasions, petitioner would give the primary dealers "orders".[11] Petitioner never received a customer order in Government securities.

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[11] An "order" is a customer's request to a dealer to purchase or sell a specified quantity of securities on the customer's behalf either at a specified price or at the best available price in the market.

Petitioner typically financed his purchases of Treasury securities through repurchase agreements. Ms. James contacted primary dealers and CF to locate the best rates. Petitioner had credit lines with 20 different primary and secondary dealers, and he could finance his purchases through any of these firms. Petitioner sometimes financed Treasury securities through a dealer other than the dealer from whom he purchased the securities. Petitioner typically dealt with a variety of counterparties in the course of acquiring, financing, and selling particular positions.

Government securities dealers usually orally confirm a trade and mail written confirmation on it. When petitioner executed trades of Treasury securities with primary dealers, the primary dealers always mailed the confirmation to B & C, sometimes to the attention of petitioner, sometimes with a reference to Account 2900, and sometimes with no reference to either petitioner or Account 2900. Petitioner almost always received repo trade confirmation from the primary or secondary dealers with whom he dealt. Petitioner never sent trade or repo confirmation to the primary dealers with whom he dealt and he never sent trade or repo confirmation to any of the counterparties with whom he dealt. When B & C executed a trade for a retail customer, B & C usually phoned the customer acknowledging that the trade had been executed and sent the customer a written confirmation.

Petitioner received monthly statements from the primary dealers with whom he dealt regularly, and he received monthly statements from other primary dealers irregularly. He never sent monthly statements to any of his primary dealer counterparties, and he never sent

monthly statements to any of his secondary dealer counterparties. B & C routinely sent monthly statements to its customers.

The Government securities dealers with whom petitioner dealt kept various records on their customers' accounts, including petitioner's. These records included customer account agreements. B & C regularly used a customer agreement for its retail customers during the subject years. Petitioner did not receive a customer account agreement from any of the counterparties with whom he dealt.

OPINION

We must decide whether petitioner's gains and losses from his dealings in Treasury securities were ordinary or capital. Whereas an individual may generally deduct from current income all ordinary losses, sec. 165(a), an individual's deduction for capital losses is limited, secs. 165(f), 1211. See *Moravec v. Commissioner*, 500 F.2d 1298 (7th Cir. 1974), affg. per curiam T.C. Memo. 1973-83. An individual may currently deduct capital losses only up to the amount of his or her capital gains plus $3,000 (or $1,500 for married individuals filing separately). He or she must carry forward any excess loss to a future taxable year. Secs. 1211(b) and 1212(b); see *Moravec v. Commissioner, supra.*

A capital loss is any loss realized on the sale or exchange of a capital asset. See sec. 1222; *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 223 (1988). A "capital asset" includes any "property held by the taxpayer (whether or not connected with his trade or business)"

that is not within one of five categories. Sec. 1221; *Arkansas Best Corp. v. Commissioner, supra* at 215. Section 1221(1), the only category that could apply here, provides that property is not a capital asset if it is:

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *

Petitioner focuses on this text and argues that his Treasury securities were not capital assets. According to petitioner, even if he did not hold the Treasury securities for sale to customers, the securities were "stock in trade" or "other property of a kind which would properly be included in * * * [his] inventory * * * if on hand at the close of the taxable year". Petitioner asserts that he bought the Treasury securities for resale, which, he concludes, means that the securities were stock in trade or inventory. Petitioner asserts that an ordinary loss arises from the sale of property in an everyday activity, such as his security trading, in which there are short holding periods, a frequency and volume of sales, and regular interaction with buyers. Alternatively, petitioner argues, he held the Treasury securities "primarily for sale to customers in the ordinary course of his trade or business". Petitioner asserts that his customers were his primary dealer counterparts; according to petitioner, the meaning of the word "customer" includes any person with whom he had established business relationships and with whom he dealt regularly on a principal-to-principal basis. Petitioner asserts that the fact that he held his

Treasury securities primarily for sale to customers is evidenced by the fact that B & C bought and held securities primarily for sale to its customers. Petitioner asserts that the mere fact that he traded on his own account, rather than on behalf of third parties, does not take him outside the definition of a dealer.

Respondent replies that petitioner's gains and losses were capital because he was not a dealer. Respondent asserts that petitioner traded for his own account and that he had no customers. Respondent asserts that petitioner had no separate place of business to conduct his trading and that he used B & C's resources to effectuate his trades. Respondent asserts that petitioner did not register as a dealer with the SEC, NASD, or Illinois secretary of state. Respondent asserts that petitioner did not treat himself as a dealer on his tax returns as originally filed.

We agree with respondent that petitioner was not a dealer in Treasury securities during the subject years. To start with, petitioner is incorrect in asserting that his Treasury securities were his stock in trade or inventory, even if he did not hold the securities for sale to customers. As courts have consistently held, securities may be classified as stock in trade or inventory only when they are held primarily for sale to customers in the ordinary course of business. *Marrin v. Commissioner*, 147 F.3d 147, 152 (2d Cir. 1998), affg. T.C. Memo. 1997-24; *United States v. Wood*, 943 F.2d 1048, 1051 (9th Cir. 1991); *Swartz v. Commissioner*, 876 F.2d 657, 659 (8th Cir. 1989), affg. per curiam T.C. Memo. 1987-582; *United States v. Diamond*, 788 F.2d 1025, 1029 (4th Cir. 1986); *Van Suetendael v. Commissioner*, 152 F.2d 654, 654 (2d Cir. 1945), affg. per curiam a

Memorandum Opinion of this Court dated Sept. 25, 1944; *King v. Commissioner*, 89 T.C. 445, 458 (1987); see *Wood v. Commissioner*, 16 T.C. 213, 225-226 (1951) ("It is well settled that property cannot be classified as stock in trade or property subject to inventory unless it is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."); see also *Kelly v. Commissioner*, T.C. Memo. 1996-529; *Tybus v. Commissioner*, T.C. Memo. 1989-309. The mere fact that petitioner may have sold the Treasury securities in the ordinary course of his trade or business, an assertion that petitioner vigorously makes but which we decline to decide, does not mean, as petitioner asks us to hold, that the securities are outside the meaning of the term "capital asset" as used in section 1221. In order to escape the broad reach of that term, and the resulting classification as a capital gain or capital loss, petitioner's sales not only must have been "in the ordinary course of his trade or business", but must have been "to customers" as well.[12] In fact, the phrase "to customers" was expressly added to the predecessor of section 1221(1) in the Revenue Act of 1934, ch. 277, 48 Stat. 680, to make it "impossible to contend that a stock speculator trading on his own account is not subject to the [capital loss limitation] provisions". H. Conf. Rept.

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[12] Petitioner, citing *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955), argues on brief that the term "capital asset" is narrowly defined for purposes of sec. 1221. We disagree. In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 222 (1988), the Supreme Court clarified that the term "capital asset" is construed broadly, and that "*Corn Products* * * * [stands] for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221."

1385, 73d Cong., 2d Sess. 22 (1934), 1939-1 C.B. (Part 2) 627, 632; see also *United States v. Diamond, supra* at 1028; *Mirro-Dynamics Corp. v. United States*, 374 F.2d 14, 16 (9th Cir. 1967); *Kemon v. Commissioner*, 16 T.C. 1026, 1032 (1951). For a detailed discussion of the legislative history of the "to customers" amendment, see *King v. Commissioner, supra* at 457-458; *Kemon v. Commissioner, supra* at 1032; *Wood v. Commissioner, supra* at 219-220.

As to petitioner's alternative argument, namely, that he sold the Treasury securities to customers, whether an individual sells securities to customers is a question of fact that hinges on his or her classification as a dealer, trader, or investor. *Kemon v. Commissioner, supra* at 1032. All purchasers of securities are within one of these three categories, and only a dealer is eligible for the section 1221(1) exception because only a dealer has customers. *United States v. Wood, supra* at 1051-1052. As the Court of Appeals for the Ninth Circuit has stated, in distinguishing these three types of purchasers:

> A dealer is a person who purchases the securities or commodities with the expectation of realizing a profit
>
> > not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middleman bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods.

Kemon v. Commissioner, 16 T.C. 1026, 1032-33 (1951). Dealers have customers for purposes of section 1221. *See United States v. Diamond*, 788 F.2d 1025, 1029 (4th Cir. 1986).

Traders, on the other hand, are sellers of securities or commodities who "depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost." *Id.* at 1033. A trader performs no merchandising functions nor any other service which warrants compensation by a price mark-up of the securities he or she sells. *Id.* at 1032-33. "[A] trader will be deemed to be engaged in a trade or business if his or her trading is frequent and substantial. *King*, 89 T.C. at 458. Generally, both dealers and traders will be engaged in a trade or business; only a dealer, however, has customers.

An investor is very similar to a trader. Like a trader, an investor "makes purchases for capital appreciation and income." *King*, 89 T.C. at 459. Unlike a trader, however, an investor makes such purchases "usually without regard to short-term developments that would influence prices on the daily market." *Id.* An investor, on the other hand, will never be considered to be engaged in a trade or business with respect to his or her investment activities, no matter how extensive his or her activities might be. *Id.* at 459. [*Id.*]

See also sec. 1.471-5, Income Tax Regs. (regulatory definition of a dealer in securities).

Petitioner was not a dealer. First, he did not conduct his trading activity in the manner in which a dealer would have. He personally owned all of the Treasury

securities that he traded, he traded those securities only for his own account, and he reported on his personal income tax returns the gains and losses on his trades. He did not make a market in Treasury securities, and he did not earn a commission on any of his trades because the counterparties thereto were not required to pay him a commission. He did not maintain a place of business for trading his securities separate from B & C's, and he did not effectuate trades pursuant to a directive. He did not treat his counterparties as customers; e.g., he did not send them confirmation, he did not have them sign customer account agreements, and he did not send them monthly statements.[13] Although he was a part owner of B & C, the business of which included trading securities to customers, he did not trade his Treasury securities in the course of that business. He merely used B & C's resources to assist him in his independent activity of trading Treasury securities. Although he asks the Court to consider his trading activity part of B & C's business activity, we decline to do so. Petitioner and B & C are separate, and, under the facts herein, we will not disregard their separateness or otherwise treat them as one. To the extent that petitioner asks the Court to conclude that he used B & C as his agent and instrumentality for purposes of trading the Treasury securities in Account 2900, the facts

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[13] Petitioner asks the Court to find that sending written confirmation was not the practice in the industry, especially in cases where, like his, all trades were confirmed orally. Petitioner also asks the Court to find that the industry practice was not to send monthly statements to, or obtain customer agreements from, institutional investors. We decline to make either finding. Neither finding is supported by reliable evidence in the record.

at hand do not support such a conclusion. The fact that petitioner personally owned his Treasury securities, that he traded them for his own account, that he did not have a separate place of business to conduct his trading, and that his only source of income from his trading depended on an increase in value all militate against categorizing him as a dealer. See *Marrin v. Commissioner*, 147 F.3d at 151; *Kemon v. Commissioner, supra* at 1032.

Second, petitioner's primary intent in trading Treasury securities was inconsistent with that of a dealer. A dealer purchases securities intending to profit primarily from selling the securities at an increased price that represents remuneration for working as a middleman and performing the usual services of retailer or wholesaler of goods. *Kemon v. Commissioner*, 16 T.C. at 1032-1033; see *Estate of Hall v. Commissioner*, 29 B.T.A. 1255, 1259-1260 (1934), affd. sub nom. *Commissioner v. Stevens*, 78 F.2d 713 (2d Cir. 1935); see also *MacAdam v. Commissioner*, T.C. Memo. 1991-410. Petitioner, by contrast, aimed to reap a profit from an increase in value caused by a favorable fluctuation in interest rates, and, but for such a favorable fluctuation, he would not have reaped any meaningful profit at all. Interest rates change daily, and petitioner speculated that the short-term course of those rates would be consistent with the course that he predicted, which, in turn, would increase the value of his securities. The mere fact that petitioner may have traded Treasury securities regularly and extensively does not necessarily mean, as petitioner would have us hold, that any purchaser of those securities was a customer of his. A profit motive that hinges on a hope or expectation of prospering from a rise in the value of a security is not indicative of a

dealer. See *United States v. Wood*, 943 F.2d at 1051-1052; see also *Marrin v. Commissioner, supra* at 151.

Third, petitioner's pool of purchasers was not indicative of that of a dealer. His pool was almost exclusively primary dealers, and most of his trades were effectuated through two of those dealers; namely, Salomon Brothers, Inc., and Goldman, Sachs & Co. He sold many of his securities to the same primary dealer from whom he had bought them. See *Van Suetendael v. Commissioner*, 152 F.2d at 654; *MacAdam v. Commissioner, supra*. Such a pool of purchasers as that maintained by petitioner is not indicative of a dealer. Accord *Marrin v. Commissioner*, 147 F.3d 147 (2d Cir. 1998) (taxpayer who bought stock from a broker and sold it to the same or another broker was not entitled to ordinary loss treatment); *Faroll v. Jarecki*, 231 F.2d 281 (7th Cir. 1956) (taxpayer who traded futures contracts on the floor of the CBT on his own behalf, and not for the account of the partnership of which he was a member or for any customer of the partnership, did not hold the contracts primarily for sale to customers in the ordinary course of his trade or business); cf. *Estate of Hall v. Commissioner, supra* (partnership was a dealer of securities even though its sales were made primarily to brokers on the New York Stock Exchange; partnership had established place of business, held itself out as a dealer, and, most importantly, did not buy the securities for investment or speculation).

Fourth, the fact that petitioner did not perform any merchandising functions or any other services which would have warranted a markup in the price of his Treasury securities is indicative of a trader. See *Kelly v. Commissioner*, T.C. Memo. 1996-529; *Furer v. Commissioner*,

T.C. Memo. 1993-165, affd. without published opinion 33 F.3d 58 (9th Cir. 1994). Petitioner used B & C's facilities and personnel to trade the securities, and he never received any remuneration for working as a middleman because he never brought a buyer and seller together. His securities were as easily accessible to one as to the other; thus, he profited only when his securities rose in value between the time that he bought them and the time that he sold them. See *Kemon v. Commissioner, supra* at 1033. The inability to mark up a security for reasons other than value appreciation is not indicative of a dealer. See *Frankel v. Commissioner*, T.C. Memo. 1989-39.

Fifth, the fact that petitioner did not consider himself a dealer during the relevant time militates against classifying him as a dealer. If petitioner had in fact been a dealer, he would have been required to register as such with the SEC, the NASD, and the Illinois secretary of state. Yet, he did not register with any of these agencies.[14] Nor did he advertise himself as a dealer. One need only examine his tax returns as originally filed to understand that he did not consider himself a dealer at the time of

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[14] Petitioner and B & C's chief financial officer testified that they believed that petitioner did not have to register individually because he and B & C were one and the same. We do not find this testimony persuasive. Even if petitioner did believe that he and B & C were one and the same when it came to partnership business, a finding that petitioner asks the Court to make but which we are unable to make because of a lack of substantiation, the subject trading of Treasury securities was not partnership business. It was an activity that petitioner conducted independently of B & C. Moreover, petitioner reported the gains and losses therefrom on his personal income tax return.

their filings. None of these returns reported that he was a dealer in Treasury securities. They reported that his gains and losses were capital. Although he testified that he did not know when he originally filed his returns that the Federal tax laws differentiated between gains and losses that were capital as opposed to ordinary, we find this testimony illogical when considered in the light of the record as a whole. Petitioner is an intelligent man who, when he filed his 1984 tax return, had been working for more than 25 years. During each year in issue, he had experienced the benefits of capital gains and the burdens of capital losses; he reported that he was unable to deduct currently $29,457,311, $48,900,546, and $93,752,481 of capital losses that he realized (exclusive of any prior year carryovers) in 1987, 1988, and 1989, respectively,[15] and he reported net long-term capital gains of $4,729,387, $42,213,314, and $53,119,895 on his 1984, 1985, and 1986 returns, respectively, for which he took into account 60-percent deductions under section 1202. We also believe that he was familiar with the classifications of dealer, trader, or investor. We discussed the difference between a dealer and a trader almost 10 years before petitioner first entered the securities industry, see *Kemon v. Commissioner*, 16 T.C. at 1032-1033, and this distinction was almost 35 years old at the time that he filed his 1984 return. We also

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[15] In other words, notwithstanding the multi-million-dollar capital losses that petitioner reportedly incurred during these years, he limited his capital loss deduction for 1987, 1988, and 1989 to $3,000 each. We also note that petitioner reported "total income" of $44,122,440, $24,267,722, and $58,882 for these respective years, and that he reported that his related tax liability was $16,243,036, $6,661,226, and $605, respectively.

take into account that all of the subject returns were prepared by large, multinational accounting firms, and that the 1985 return noted specifically that petitioner was a "trader", and not an "investor".[16] The fact that petitioner did not have himself licensed as a dealer, that he did not consider himself a dealer, and that he did not hold himself out as a dealer undercuts his argument that he was one. See *Mirro-Dynamics Corp. v. United States*, 374 F.2d 14 (9th Cir. 1967); see also *Furer v. Commissioner, supra; Michelson v. Commissioner*, T.C. Memo. 1990-27, affd. 951 F.2d 288 (10th Cir. 1991); *Tybus v. Commissioner*, T.C. Memo. 1989-309; *Huebschman v. Commissioner*, T.C. Memo. 1980-537.

Petitioner argues vigorously that his customers were the primary dealers to whom he sold the securities. We do not agree. Petitioner's proffered definition of the word "customer", to wit, any person with whom he had established business relationships and with whom he dealt regularly on a principal-to-principal basis, misses the mark. As we stated in *Frankel v. Commissioner, supra*, in refusing to adopt a similar definition that was proffered

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[16] Petitioner testified that he retained Coopers & Lybrand to prepare his tax returns because it was more familiar than Peat, Marwick with the securities area. Petitioner implied during his testimony that Coopers & Lybrand saw that Peat, Marwick had incorrectly classified him as a "dealer", and that Coopers & Lybrand amended his 1985 through 1989 returns to correct Peat, Marwick's mistake. We are unpersuaded by this testimony. As a point of fact, petitioner's 1989 tax return classified petitioner as a trader, and this return was prepared by Coopers & Lybrand.

by the taxpayer there,[17] a "seller of securities who does not perform a merchandising function – who does not act as a middleman bringing buyer and seller together – is considered a trader, and as such, not even the broadest array of vendees will be his 'customers' ".

Although not identical, the instant case is analogous to *Frankel v. Commissioner, supra*. There, the taxpayer was an associate of an investment firm who began trading GNMA's for his own account in 1977. With one exception, he sold the GNMA's back to the same primary dealer from whom he had purchased them. In 1980, he stopped trading GNMA's and began trading Treasury securities through accounts which he maintained with primary dealers. We rejected his argument that he was a dealer and that the primary dealers were his "customers". We stated:

> The fact that petitioner did not trade on an organized exchange, but rather dealt directly with the primary traders, is of no consequence due to the fact that there existed no GNMA exchange. * * * Petitioner was a trader, not a dealer, and the primary dealers with whom petitioner traded were not his "customers," rather, he was theirs.
>
> Petitioners would have us look to a myriad of other factors in defining a trader and a dealer. However, we point out that, unlike a dealer, a trader has no 'customers' and trades only on his

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[17] The taxpayer in *Frankel v. Commissioner*, T.C. Memo. 1989-39, asked the Court to adopt a definition under which a "customer" is "any person who buys an asset from another person".

> own account. However, the trading activity in which traders engage may resemble the activity of a dealer in every other respect. It is possible that the trading activity of a trader may rise to the level of a trade or business of selling securities, but, nevertheless, such sales still produce capital gains and losses. *King v. Commissioner, supra,* at 457. The distinguishing characteristic between a trader and a dealer is the presence of "customers." [*Id.*]

Petitioner argues that *Frankel v. Commissioner, supra,* is distinguishable because petitioner's trading activity was more extensive than that of the taxpayer in *Frankel.* We disagree that this fact is a meaningful distinction. As in *Frankel,* the primary dealers with whom petitioner traded Treasury securities through his personal account were not his "customers", and, consistent with *Frankel,* the absence of "customers" properly characterizes petitioner as a trader even though his trading activity may have resembled the activities of a dealer in some respects. See *Marrin v. Commissioner,* 147 F.3d 147 (2d Cir. 1998) (taxpayer who bought stock from a broker and sold it to the same or another broker did not sell the stock to customers); *Faroll v. Jarecki,* 231 F.2d 281 (7th Cir. 1956) (taxpayer who traded futures contracts on the floor of the CBT on his own behalf did not sell the contracts to customers).

We sustain respondent's determination on this issue. In so doing, we have considered all arguments made by petitioner for a contrary holding, and, to the extent not

addressed above, find them to be irrelevant or without merit.

Because other issues remain to be tried,

An appropriate order will be issued.

UNITED STATES TAX COURT

WASHINGTON, DC 20217

GARY K. BIELFELDT AND CARLOTTA J. BIELFELDT,	)	Docket No. 5936-96
Petitioners,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

ORDER

On February 22, 2000, the parties filed a Joint Motion to Revise Decision in the above-entitled case. The decision entered in this case on February 2, 2000, contained an error concerning the overpayment for the taxable year 1985. The parties have submitted a new re-executed decision document including the year disputed in this matter for the Court's entry. Upon due consideration, it is

ORDERED that the joint motion to revise decision is granted in that the decision entered on February 2, 2000, is vacated and set aside.

(Signed) David Laro

David Laro
Judge

Dated: Washington, D.C.
March 1, 2000

UNITED STATES TAX COURT

GARY K. BIELFELDT and CARLOTTA J. BIELFELDT, Petitioners,	)	Docket No. 5936-96
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed November 6, 1998, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDER AND DECIDED: That there is an overpayment in income tax for the taxable year 1984 in the amount of $2,592,271.00, which amount was paid on April 15, 1985, and for which amount a claim for refund was filed on April 11, 1988, which was within the period provided by I.R.C. § 6511(b)(2), and which claim had not been disallowed before the date of the mailing of the notice of deficiency;

That there is an overpayment in income tax for the taxable year 1985 in the amount of $15,835,847.00, which amount was paid on April 15, 1986, and for which amount a claim for refund was filed on April 11, 1988, which was within the period provided by I.R.C. § 6511(b)(2), and which claim had not been disallowed before the date of the mailing of the notice of deficiency;

That there are deficiencies in income taxes due from the petitioners for the taxable years 1986, 1987 and 1988 in the amounts of $9,451,300.00; $4,328,578.00 and $4,077,252.00, respectively;

That there are no additions to the tax due from the petitioners for the taxable years 1984 and 1985, under the provisions of I.R.C. § 6653(a)(1);

That there are no additions to the tax due from the petitioners for the taxable years 1984 and 1985, under the provisions of I.R.C. § 6653(a)(2);

That there are no additions to the tax due from the petitioners for the taxable years 1986 and 1987, under the provisions of I.R.C. § 6653(a)(1)(A);

That there are no additions to the tax due from the petitioners for the taxable years 1986 and 1987, under the provisions of I.R.C. § 6653(a)(1)(B);

That there is no addition to the tax due from the petitioners for the taxable year 1988, under the provisions of I.R.C. § 6653(a)(1); and

That there are no additions to the tax due from the petitioners for the taxable years 1985, 1986, 1987 and 1988, under the provisions of I.R.C. § 6661.

(Signed) David Laro
Judge.

Entered: MAR 2 2000

* * *

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computations, and that the Court may enter this

decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

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Date: FEB 14 2000

United States Court of Appeals

For the Seventh Circuit

Chicago, Illinois 60604

CORRECTED JUDGMENT
WITH ORAL ARGUMENT

Corrected Date: November 9, 2000

BEFORE: Honorable RICHARD A. POSNER,
Circuit Judge

Honorable JOHN L. COFFEY,
Circuit Judge

Honorable MICHAEL S. KANNE,
Circuit Judge

No. 00-1747

GARY K. BIELFELDT and CARLOTTA J. BIELFELDT,
Petitioners – Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent – Appellee

Appeal from an order of the United States Tax Court
No. 5936-96

The judgment of the United States Tax Court is AFFIRMED, with costs in accordance with the decision of this court entered on November 8, 2000.

(1182-110894)

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

January 8, 2001

Before

Hon. Richard A. Posner, *Circuit Judge*

Hon. John L. Coffey, *Circuit Judge*

Hon. Michael S. Kanne, *Circuit Judge*

No. 00-1747

GARY K. BIELFELDT and CARLOTTA J. BIELFELDT,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court.

No. 5936-96

ORDER

On consideration of the petition for rehearing filed on December 21, 2000 by petitioners-appellants. All of the judges on the panel have voted to deny the petition. The petition is therefore **DENIED**.

Supreme Court, U.S.
FILED
JUN 8 2001
OFFICE OF THE CLERK

No. 00-1545

In the Supreme Court of the United States

GARY K. BIELFELDT AND CARLOTTA J. BIELFELDT,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the trading by petitioner in United States Treasury securities resulted in capital losses or ordinary losses.

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In the Supreme Court of the United States

No. 00-1545

GARY K. BIELFELDT AND CARLOTTA J. BIELFELDT,
PETITIONERS
v.
COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-7) is reported at 231 F.3d 1035. The opinion of the Tax Court (Pet. App. 8-42) is unofficially reported at 76 T.C.M. (CCH) 776.

JURISDICTION

The judgment of the court of appeals was entered on November 8, 2000. The petition for rehearing was denied on January 8, 2001. Pet. App. 48. The petition for a writ of certiorari was filed on April 6, 2001. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Between 1985 and 1989, petitioner Gary K. Bielfeldt traded Treasury securities through Bielfeldt & Co., a partnership in which he held a partnership interest.[1] Treasury securities are initially sold through auctions conducted by the Department of the Treasury. Pet. App. 12. Between the date of announcement of an upcoming auction and the issuance of securities after the auction Treasury securities are traded on a "when-issued" basis. *Id.* at 13 n.3. After their issuance, Treasury securities are traded predominantly in an over-the-counter market that is comprised of a network of dealers, brokers and investors who effect transactions in the securities over the telephone. *Id.* at 12-13. Petitioner traded primarily with "primary dealers," which are the firms designated by the Federal Reserve Bank of New York to deal with the Federal Reserve in the Treasury securities market. *Id.* at 20-22. The issue in this case is whether petitioner's transactions in these securities gave rise to capital losses or ordinary losses.

Section 1221 of the Internal Revenue Code generally defines a "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business) * * *." 26 U.S.C. 1221. The statute specifies, however, that this term does not include (26 U.S.C. 1221(1)):[2]

> stock in trade of the taxpayer or other property of a kind which would properly be included in the

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[1] Petitioner's wife, Carlotta J. Bielfeldt, is a party to this case solely because she filed joint federal income tax returns with her husband during the relevant taxable years.

[2] This statute was redesignated as 26 U.S.C. 1221(a)(1) (Supp. V 1999) by the Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 532(a)(1)-(3), 113 Stat. 1928-1930.

inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

On his federal tax returns for the years 1985 to 1989, petitioner initially took the position that his transactions in Treasury securities gave rise to capital gains and capital losses. Pet. App. 10. Petitioner subsequently filed amended returns for those years, however, that took the position that these transactions gave rise to ordinary income and ordinary losses. *Id.* at 11. If these trading losses were properly recharacterized from capital to ordinary losses, petitioner would be allowed to use the net trading losses incurred in these years to offset ordinary income from other sources he reported in these and other years.[3] *Ibid.* Based on the theory that these losses were ordinary rather than capital in nature, petitioner claimed tax refunds of $3,202,380 for 1984, $19,781,480 for 1985, $39,160,798 for 1986, $16,232,812 for 1987, and $6,658,075 for 1988. *Ibid.*

The Commissioner of Internal Revenue disallowed the refund claims and asserted deficiencies in tax and additions to tax against petitioner for the years 1984 through 1988. Petitioner challenged these determinations in Tax Court and also sought the refunds claimed on his amended returns.

2. The Tax Court held that petitioner incurred capital, rather than ordinary, losses from his trading in

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[3] As the court of appeals explained (Pet. App. 2), this would occur because the Internal Revenue Code generally allows ordinary losses to be offset against ordinary income in their entirety but precludes an individual taxpayer from deducting more than $3000 in capital losses from ordinary income. See 26 U.S.C. 1211(b).

Treasury securities. Pet. App. 28-42. The court initially rejected petitioner's contention that the Treasury securities he traded were part of his "stock in trade or inventory" within the meaning of Section 1221(1). The court explained that "courts have consistently held [that] securities may be classified as stock in trade or inventory only when they are held primarily for sale to customers in the ordinary course of business." *Id.* at 30. The court noted that Congress added the phrase "to customers" to the predecessor of Section 1221(1) for the express purpose of making "it 'impossible to contend that a stock speculator trading on his own account is not subject to the [capital loss limitation] provisions.'" *Id.* at 31 (quoting H. R. Conf. Rep. No. 1385, 73d Cong., 2d Sess. 22 (1934)).

The Tax Court also rejected petitioner's contention that he had sold Treasury securities "to customers" within the meaning of Section 1221(1). The court observed that "whether an individual sells securities to customers is a question of fact that hinges on his or her classification as a dealer, trader, or investor" and that "only a dealer is eligible for the section 1221(1) exception because only a dealer has customers." Pet. App. 31. The court concluded that petitioner was not a dealer in Treasury securities because "he did not conduct his trading activity in the manner in which a dealer would have," because "his primary intent in trading Treasury securities was inconsistent with that of a dealer," because he dealt only with "primary dealers" rather than with customers, because he "did not perform any merchandising functions or any other services * * * indicative of a trader," because he "did not consider himself a dealer during the relevant time" and because he "did not register" or advertise as a dealer. *Id.* at 31-38.

3. The court of appeals affirmed. Pet. App. 1-7. The court held that petitioner was a "speculator," and not a "dealer," for federal tax purposes. *Id.* at 5-6. The court noted that petitioner (*ibid.*):

> hoarded Treasury securities during the fat weeks immediately after an auction so that there would be an adequate supply in the lean weeks (the weeks between auctions) that followed. That activity may have been socially beneficial, as he argues, but it is no different from the social benefits of speculation generally. His argument if accepted would turn every speculator into a dealer for purposes of the Internal Revenue Code.

The court of appeals also rejected petitioner's contention that he incurred ordinary losses from his transactions in Treasury securities because the function he performed was analogous to the function performed by a "floor specialist" on a stock exchange (Pet. App. 6):

> Unlike a floor specialist, [petitioner] undertook no obligation to maintain an orderly market in Treasury securities. He did not maintain an inventory of securities; and because he skipped auctions that didn't seem likely to produce the glut that was the basis of his speculative profits, there were months on end in which he could not have provided liquidity by selling from inventory because he had no Treasury securities. * * * He was a speculator, period. As the Federal Reserve Bank of New York, which kept track of [petitioner's] trading in Treasury securities and sent updates to the IRS, put it, "his activities are in most cases outright speculation on interest rate movements."

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. a. The Internal Revenue Code generally allows a deduction from gross income for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." 26 U.S.C. 165(a). There is an exception from that general rule, however, for losses that result from the sale or exchange of "capital assets." 26 U.S.C. 165(f). Such "capital" losses may be deducted "only to the extent allowed in sections 1211 and 1212." 26 U.S.C. 165(f). Under Section 1211(b) of the Code, losses from sales or exchanges of "capital assets" by an individual taxpayer are "allowed only to the extent of the gains from such sales or exchanges, plus * * * the lower of $3,000 * *-* or the excess of such losses over such gains." 26 U.S.C. 1211(b). In other words, an individual taxpayer may deduct a maximum of $3000 in capital losses from his ordinary income for a particular year.

The Code generally defines a "capital asset" for this purpose as "property held by the taxpayer (whether or not connected with his trade or business) * * *." 26 U.S.C. 1221. This term, however, expressly does not include (26 U.S.C. 1221(1)):

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Losses from the sale or exchange of property encompassed by Section 1221(1) are generally deductible in full from ordinary income (pursuant to Section 165(a) of the Code).

b. In interpreting the phrase "property held * * * primarily for sale to customers" in Section 1221(1), courts consistently have drawn a distinction between "dealers" who keep a supply of securities on hand for resale to customers (and derive ordinary income and ordinary losses from their transactions) and "traders" who trade in securities for their own accounts (and derive capital gains and capital losses from their transactions). See, *e.g.*, *Marrin* v. *Commissioner*, 147 F.3d 147, 151 (2d Cir. 1998); *Mirro-Dynamics Corp.* v. *United States*, 374 F.2d 14, 16 (9th Cir.), cert. denied, 389 U.S. 896 (1967); *Gruver* v. *Commissioner*, 142 F.2d 363, 368 (4th Cir. 1944); *Commissioner* v. *Burnett*, 118 F.2d 659, 660 (5th Cir. 1941).[4] As the court of appeals correctly explained in this case (Pet. App. 2):

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[4] Petitioner errs in asserting (Pet. 17-18) that the decision in this case "creates a direct and irreconcilable conflict between the Seventh Circuit and the specific decisions of this Court in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), and *Corn Products Ref. Co. v. Commissioner*, 350 U.S. 46 (1955)." The issues addressed in those cases were not even remotely related to the issue presented in this case. Those cases concerned the extent to which ordinary or capital gains or losses resulted from (i) a taxpayer's acquisition of commodity futures as a "hedge" against future business needs for that commodity (*Corn Prods.*, 350 U.S. at 51-52) or (ii) a company's acquisition of bank stock for the purpose of protecting that company's business reputation (*Arkansas Best*, 485 U.S. at 215). Neither of those decisions dealt with the question addressed in this case. As we have noted in the text, the courts that *have* addressed the question addressed here have uniformly held that securities speculators such as petitioner cannot claim ordinary losses from their transactions.

> The standard distinction between a dealer and a trader is that the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely, fluctuations in the market value of the securities or other assets that he transacts in.

Accord, *e.g*, *Marrin* v. *Commissioner*, 147 F.3d at 151; *United States* v. *Wood*, 943 F.2d 1048, 1051 (9th Cir. 1991); *Stephens, Inc.* v. *United States*, 464 F.2d 53, 57 (8th Cir. 1972), cert. denied, 409 U.S. 1118 (1973).

c. The record of this case amply supports the Tax Court's factual determination (Pet. App. 30-42) that petitioner was a trader, and not a dealer, in Treasury securities during the relevant taxable period. For example, the record establishes that (i) petitioner personally owned all of the Treasury securities that he traded and traded those securities only for his own account (*id.* at 33-34), (ii) petitioner did not earn a commission on any of his trades and did not effectuate trades pursuant to a directive from any customer (*id.* at 34), (iii) petitioner did not treat other parties as customers (*ibid.*), (iv) petitioner did not perform any merchandising functions (*id.* at 36-37) and (v) petitioner did not consider himself a dealer, or register as a dealer, during the relevant time period (*id.* at 37-38). Based upon this factual record, the court of appeals concurred in the Tax Court's finding that petitioner acted as a trader, rather than a dealer, and therefore did not incur ordinary losses from his trading in Treasury securities.[5]

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[5] Petitioner erroneously refers to himself as a "specialist" (Pet. 6, 20). The Seventh Circuit correctly observed (Pet. App. 6) that

That factual determination, which was "concurred in by two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)), does not warrant review by this Court. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. Petitioner nonetheless asserts (Pet. 8-17) that the court of appeals erred by not overturning the allegedly erroneous legal conclusion of the Tax Court that securities can constitute "stock in trade" under 26 U.S.C. 1221(1) only if they are held primarily for sale to customers. The premise underlying that argument—that securities traded by an individual who has no customers and trades exclusively for his own account can be part of his "stock in trade" within the meaning of Section 1221(1)—is at odds with common sense and with the language and legislative history of the statute. It is also refuted by the overwhelming and unanimous body of case law. *Van Suetendael* v. *Commissioner*, 152 F.2d 654 (2d Cir. 1945) (securities "could not be classified as stock in trade or property subject to inventory unless they were held by the taxpayer primarily for sale to customers in the ordinary course of his business"); see also *Swartz* v. *Commissioner*, 876 F.2d 657, 659 (8th Cir. 1989), cert. denied, 494 U.S. 1006 (1990); *Mirro-Dynamics Corp.* v. *United States*, 374 F.2d at 16.

The term "stock in trade" is generally defined as "[t]he inventory carried by a retail business for sale in the ordinary course of business." *Black's Law Dictionary* 1418 (6th ed. 1990). The term properly encompasses the supply of securities maintained by a taxpayer to take care of future buying orders in excess of

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petitioner did not engage in any activities that were comparable to the activities performed by a "specialist" on a stock exchange.

selling orders. Because "stock in trade" is part of the "inventory" of a business, however, the term obviously cannot encompass securities that are traded by an individual who has no customers and trades exclusively for his own account. *United States* v. *Nordberg*, 96-1 U.S. Tax. Cas. (CCH) ¶ 50,295, at 84,088 (D. Mass.) ("A taxpayer without customers likewise cannot satisfy the first clause of § 1221(1) to wit, hold the securities as 'stock in trade . . . which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.'"), aff'd, 97 F.3d 1445 (1st Cir. 1996), cert. denied, 519 U.S. 1078 (1997). Securities traded by a taxpayer for his own account are not part of his business inventory for federal tax purposes. *Mirro-Dynamics Corp.* v. *United States*, 374 F.2d at 16. Treasury regulations make this clear by specifying that only a dealer in securities may hold unsold securities as inventory. 26 C.F.R. 1.471-5. The regulations further define a "dealer in securities" as (*ibid.*):

> a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. * * * Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section. * * *

Petitioner was not a merchant of Treasury securities because he bought and sold these securities solely for speculative purposes. These securities thus cannot form "stock in trade" within the meaning of Section 1221(1).

The legislative history of the governing statutory provisions confirms that petitioner's transactions are capital rather than ordinary in nature. Prior to 1934, the revenue statutes had provided that:

> [t]he term 'capital assets' means property held by the taxpayer for more than two years (whether or not connected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

Revenue Act of 1926, ch. 27, § 208(a)(8), 44 Stat. 19. In the Revenue Act of 1934, ch. 277, § 117(b), 48 Stat. 714, Congress added the phrase "to customers" to the term "property held by the taxpayer primarily for sale" in order "to prevent tax avoidance by making it abundantly clear that a stock speculator buying and selling securities for his own account and not for resale to customers was subject to the limitation on the deductibility of capital losses provided in § 117 of the Act." *Gruver* v. *Commissioner*, 142 F.2d 363, 368 (4th Cir. 1944). See H.R. Conf. Rep. No. 1385, *supra*, at 22; *Marrin* v. *Commissioner*, 147 F.3d at 151. Petitioner is precisely the type of large speculator who buys and sells securities for his own account that the 1934 amendment ensured would be subject to the capital loss limitation provisions of Section 1221.

Petitioner errs in asserting (Pet. 9-10) that *Gilbert* v. *Commissioner*, 56 F.2d 361 (1st Cir. 1932), supports a different conclusion. In that case, the court of appeals held that certain stock owned by a taxpayer was not a capital asset under the pre-1934 version of Section 1221(1). In reaching that conclusion, the court reasoned that the stock was "held by the taxpayer primarily for sale in the course of his trade or business" within the meaning of the pre-1934 version of the statute. *Id.* at 362. That decision, however, was plainly based upon the text of the statute before it was amended for the very purpose of precluding speculators such as petitioner who buy and sell securities on their own account from claiming ordinary losses from their activities. See *Gruver* v. *Commissioner*, 142 F.2d at 368; page 11, *supra*. Because the decision in *Gilbert* is not based upon the same statutory language involved in the present case, it cannot be said to conflict with the decision in this case.

3. We do not agree with petitioner's suggestion that the decision in this case will have an adverse impact on "the efficient working of the Treasury cash market" (Pet. 19). There is no evidence in this record—or any other evidence of which we are aware—to suggest that applying the same tax rules to petitioner that have long applied to all other securities speculators will have any adverse effect on the market for Treasury securities. The court of appeals stressed that it was not addressing the tax treatment of a trader in Treasury securities who (unlike petitioner) conducted activities that resemble those of a floor specialist on a stock exchange. Pet. App. 6. Nothing in the narrow and fact-specific decision in this case will place the ordinary and efficient marketing of Treasury securities at risk.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Attorneys

JUNE 2001